HILLSIDE ADVISORS LLC

October 19, 2015

# Hybrid Vigor℠

The Hillside Convertible Advisory Letter
Volume 2 Issue 40

# The Residue of Design

## Inside



## Our Team

*Bill Feingold*
Managing Principal

*George Chuang*
Managing Principal

*Jeffrey Alton*, CFA
Head of Equity Research

*Kathy Schick*
Head of Credit Research

*George Lynch*
Senior Analyst

*Roman Terekhin*, CFA
Senior Analyst

*Curt Peters*
Senior Analyst

*John Anderson*
Director of Business Development

*Sue Wu*
Associate

If you're a Mets fan (and I am), no matter what else is going on, things are good right now. And it's largely due to the exploits of one Daniel Murphy. How does a guy go from being a career singles and doubles hitter to the second coming of Babe Ruth or Darryl Strawberry? How does a guy known for bonehead baserunning make the most heads-up play in years at the most critical time?

As usual, we'll try to put something that has nothing to do with convertibles into a convertible context. Let's start with the fundamentals. You take someone who's pretty good, but certainly not great, at their job. They grind away, year after year, with a mediocre group of co-workers. Then, finally, you surround them with some serious talent. Maybe the person feels threatened, loses confidence, and starts underperforming. It can happen to the best of us. Then again, perhaps the person feels more comfortable, because he or she no longer has to try to carry the whole team. Ironically, this state of relaxation produces better results, to the point where the player finally can take on that role when necessary.

It's impossible to predict how changing the team will affect a given player. Getting the right mix goes by the name of management. So, let's talk portfolio management, convertible style.

Part of the beauty of convertibles is you never know which of your players is going to be your star. You don't really have to. You assemble a team—I mean, a portfolio—with certain expectations for each player, but you know up front that you're going to be right with some and wrong with others. You just hope your rights do a lot more good than your wrongs do harm. Call it the Hippocratic Oath for portfolio managers. Fortunately, the convertible asset class is pretty well designed for that purpose.

So maybe a bond that you figured for perhaps a 5 or 10% gain ends up gaining 50% or more. Call it your Daniel Murphy. Put a solid player amidst a solid team and hope for the best. Hope may not be a trading strategy, as a former boss of mine once said. Then again, perhaps the greatest baseball executive of all time, Branch Rickey, told us that "luck is the residue of design." Put a good team—er, portfolio—together and watch the pleasant surprises follow.

Bill
bill@hillsideadvisors.com

Hillside Advisors, LLC
400 Columbus Ave., Suite 240E
Valhalla, NY 10595
+ 1 (646) 712-9289
www.hillsideadvisors.com

Contact us:
info@hillsideadvisors.com

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October 19, 2015

# Oh So Slow

Bill Feingold
bill@hillsideadvisors.com

Curt Peters
curtp@hillsideadvisors.com

*A quick refresher. HARP, or Hillside Adjusted Risk Points, is best thought of as a warning measure for bonds exposed to a blend of absolute price decline and premium decay. The higher the HARP, the more dangerous the bond. HARP tends to be highest for bonds in the 120-130 "death trap" range.*

Despite being a full week for equity markets and a short week for bond markets, the Ugly 20 acted like it was a week of holidays. Average HARP change was a measly 0.01 increase to 9.40. No new entrants, and not even any new members in the top 10. How about those Mets? In all seriousness – and the Mets are very serious – this week, in lieu of activity, we'll attempt to suss out some of the hidden mysteries of HARP by way of example.


Air Lease 3.875% of 2018 has been inching up the Ugly 20 every week for the past month, landing this week at fifth position – same as last week, but with nearly a full point increase in HARP of 0.99 to 11.05. The stock reversed direction this week, putting in a 5.54% move – enough for a corresponding four point decline in the bond. The move was a hair short of delta neutral, which only added to the problem of increasing gamma as the bond falls down into the fat premium region. The bond price of 133½ puts the bond deeper into the top end of the multi-dimensional risk zone, and hence the increase in HARP. Or in other words, premium is increasing faster than par is approaching. With parity moving lower to 108¾, premium expanded from 19.9% to 23.2%. The sizable (in these times) coupon covers up just short of half of the premium effects, reducing the potential loss to 13¼ points – which is still a whopper of a risk. Air Lease has an equity volatility that is pretty much mid-range for a convertible – low 30's – which means that the volatility figure has little impact on dampening or enhancing the HARP score. However, where the bond does get some HARP-relief is on the call protection side of things. With just slightly over three years left until maturity, there is ample time to get this downtrend turned around.

Sometimes it's best to compare and contrast two items to better understand a concept, in other words, The Tale of Two Bonds. Both ServiceNow 0% of 2018 and Workday tranche 2 1.5% of 2020 are priced at 119¼. Clearly the same price is only a coincidence, as every convert bond investor knows there is a lot more to a bond than price. Surely the volatility is different (and we apologize in advance for calling you Shirley). Nope, low 30's for both. What about premium? Ah yes, now the differences start to become apparent: Workday with a 24% premium and ServiceNow with 15.2%. But let's adjust those premiums for the different coupons and see if they really are so different. After coupons, ServiceNow is still 15¾ points of potential loss, while Workday slims more noticeably to 16. A smidgen ¼ point separates the two bonds! What does HARP say about all this? ServiceNow get scored at 8.48, while Workday is less than a quarter notch higher at 8.65. Why didn't the ¼ point of potential loss translate directly into a ¼ point of HARP difference? Call protection. While both bonds are powered by the same volatility, Workday has an additional 1¾ years of call protection to burn through the almost equal amount of potential loss. To sum up, premium offset by coupons and call protection make the two bonds near twins in both price and risk.

With such a slow week, please excuse us as we reach down below our 20-name cut off, and grab number 21 – Alon USA Energy 3% of 2018. The bond has been on a HARP tear recently, this week coming all the way up from 35th. The crude refiner took a hit to the equity of 6.38% and a 6 point loss on the bonds. It's another one of those falling angels stories – as the bond price falls into the 130's zone, the premium expands and the gamma grows. In this case with a 131 bond price and 11 points of premium, the HARP pushed out by 1.12 to 7.41. It's a tough neighborhood, so be careful out there.

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October 19, 2015

## Hillside Ugly 20 List (Prices as of October 15, 2015)

| | Convertible | Price | Stock | Premium (%) | Premium (pts) | HARP |
|---|---|---|---|---|---|---|
| 1 | Lam Research Tranche B 1.25% 2018-05-15 | 130.25 | 68.28 | 18.20 | 20.06 | 13.31 |
| 2 | Red Hat 0.25% 2019-10-01 | 125.50 | 77.62 | 18.80 | 19.86 | 12.08 |
| 3 | RPM International 2.25% 2020-12-15 | 113.25 | 43.92 | 36.30 | 30.16 | 11.70 |
| 4 | Priceline.com 0.35% 2020-06-15 | 122.75 | 1336.57 | 20.70 | 21.05 | 11.47 |
| 5 | Air Lease 3.875% 2018-12-01 | 133.50 | 32.57 | 23.20 | 25.14 | 11.05 |
| 6 | Emergent BioSolutions 2.875% 2021-01-15 | 119.00 | 30.96 | 24.60 | 23.49 | 10.15 |
| 7 | BioMarin Pharma 0.75% 2018-10-15 | 134.25 | 108.84 | 16.20 | 18.72 | 9.84 |
| 8 | BioMarin Pharma 1.5% 2020-10-15 | 138.25 | 108.84 | 19.50 | 22.56 | 9.54 |
| 9 | Euronet Worldwide 1.5% 2044-10-01 | 124.25 | 75.94 | 18.00 | 18.95 | 9.50 |
| 10 | Salesforce.com 0.25% 2018-04-01 | 131.75 | 78.77 | 11.20 | 13.27 | 9.03 |
| 11 | Trinity Industries 3.875% 2036-06-01 | 129.00 | 26.58 | 21.10 | 22.48 | 8.88 |
| 12 | Workday Tranche 2 1.5% 2020-07-15 | 119.25 | 78.69 | 24.00 | 23.08 | 8.65 |
| 13 | ServiceNow 0% 2018-11-01 | 119.25 | 76.46 | 15.20 | 15.73 | 8.48 |
| 14 | Workday Tranche 1 0.75% 2018-07-15 | 115.00 | 78.69 | 21.60 | 20.43 | 8.11 |
| 15 | SanDisk 1.5% 2017-08-15 | 149.25 | 69.97 | 8.10 | 11.18 | 7.94 |
| 16 | Standard Pacific 1.25% 2032-08-01 | 117.00 | 40.95 | 15.50 | 15.70 | 7.81 |
| 17 | Sunpower 0.75% 2018-06-01 | 118.75 | 24.55 | 20.60 | 20.28 | 7.79 |
| 18 | Rambus 1.125% 2018-08-15 | 128.25 | 13.77 | 12.50 | 14.25 | 7.72 |
| 19 | Green Plains Renewable 3.25% 2018-10-01 | 119.00 | 20.83 | 18.80 | 18.83 | 7.50 |
| 20 | Healthsouth Exchan 2% 2043-12-01 | 115.25 | 38.90 | 13.50 | 13.71 | 7.44 |

Sources: Bloomberg, Kynex

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# HOCS℠ 20

Bill Feingold
bill@hillsideadvisors.com

*A quick refresher. HOCS, or Hillside Overall Convertible Score, measures the attractiveness of a bond, taking into account both upside potential and downside protection. HOCS is not a theoretical model but a rating system that assigns points to a number of different characteristics of each convertible. HOCS can theoretically lie anywhere from 0 to 100. In practice the average score for a broad group of convertibles is typically around 50. 60 is a good score, 70 is excellent, and 80 is exceptional.*

We have several lessons, after a fashion, from the past week's performance.

In general, the marginal benefit of diversification starts dropping off rapidly once you get past a dozen names or so, assuming the names are reasonably distinct from one another. Now and then, though, you get a big enough move in one of the names that even a group of 20 or so can be vulnerable. No great revelation here, but it's a reminder of why we use HOCS 100 and not the smaller groupings to view the health of the overall convertible market through HOCS-shaped lenses.

So let's start with HOCS 100 before getting to our other lessons. It returned 66 basis points last week, bringing year-to-date performance to 1.36%, or a few basis points higher than year-to-date coupon income. HOCS 100's arch-rival, the CWB exchange-traded fund, used a gain of 91 basis points last week to move into positive territory (0.86%) for the year. So while convertibles aren't exactly hitting the ball out of the park this year, they're still doing better than the broad big-cap stock indices, while slightly underperforming the NASDAQ at this point. Perhaps more notably, convertibles are a few points ahead of the IWM, the Russell 2000 ETF, which is down just over 2.5% for the year. Conventional wisdom holds that the Russell is the best broad benchmark (BBB) for convertible underlying shares. We can hear the rating agencies crying foul already.

Ok, lesson time. One is that maybe including some Chinese convertibles in your portfolio—especially some of the larger and seemingly more trustworthy ones—may not be a bad thing. Once again the traditional HOCS 20 outperformed the China-free version. Original-recipe HOCS 20 actually outperformed the HOCS 100 for the week, 84 basis points to 66. Ctrip's two entrants were among the best bonds of the week, with the 1.99% returning 2.7% and the 1% bringing home 2.4%. The week's top performer was Restoration Hardware, evidently thanks to a well-received investor presentation on Thursday. The new zeroes returned 3.3% and the old ones were just a bit behind at 3%. Meanwhile, at the top of the list, Horizon Pharmaceuticals' 2.50% were unchanged, while Isis Pharmaceuticals' 1% returned 2.4%, as the recently brutalized health-care names firmed up late in the week.

So, you ask, what happened to China-free HOCS 20? Ouch. In throwing out the Chinese names, we have to replace them. As it turned out, the replacement names (other than, ironically, longtime leader Tesla 1.25%) had a world of hurt. Taking the brunt was Renewable Energy 2.75%, which provided lower guidance thanks to lower energy prices that were not offset by commensurate declines in biodiesel inputs. The company switched its guidance from slightly positive to negative EBITDA. The bonds lost 8.3% in sympathy with an 18.3% stock decline. Thanks to REGI, and to a lesser degree to another "replacement" name, Solar City, the China-free HOCS 20 actually lost 22 basis points on the week.

Another lesson. Sometimes it's good to be a paper measure rather than a real-market one, at least when it comes to moving illiquid convertibles out of a portfolio. Renewable Energy's bonds no longer qualify for China-free HOCS 20. So we get to just drop it out. Not so easy for those who own the bonds in bulk, if they view the latest developments as a reason to exit, or if they need to raise cash. We note that the weighting of the bonds in HOCS 100 is less than one-fifth of its weighting in HOCS 20—the relatively high HOCS score offset by the small issue size.

Take that money, watch it burn, sink in the river, the lessons I learned.

This week's HOCS 20, original recipe, comes in at a bond price of 95.55, yielding 3.23%, carrying a premium of 56.4% and an overall HOCS of 74.1. China-free, meanwhile, is at virtually the same price point (95.35), profiling at 2.84% up 49.2%, with a 72.0 overall HOCS. Notably, the group that includes Chinese names has an average safety rating of 71.7 versus 65.6 for China-free—even though we have included a penalty factor for Chinese names. Perhaps safety, like beauty, lies at least partly in the eye of the beholder.

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## Hillside HOCS 20 List

| | Description | Convert | Stock | HOCS Overall | HOCS Growth | HOCS Safety | Yield | Premium |
|---|---|---|---|---|---|---|---|---|
| 1 | HORIZON PHARMA INV LTD 2.50% 2022-03-15 | 98.00 | 19.27 | 82.3 | 84.9 | 77.1 | 2.84% | 45.7% |
| 2 | ISIS PHARMACEUTICALS INC 1.00% 2021-11-15 | 96.75 | 44.62 | 81.4 | 82.7 | 78.6 | 1.56% | 44.9% |
| 3 | QIHOO 0.50% 2020-08-15 | 90.50 | 54.89 | 79.0 | 73.2 | 90.6 | 6.11% | 106.6% |
| 4 | CTRIP.COM INTER LTD. 1.99% 2025-07-01 | 95.00 | 71.05 | 78.9 | 90.8 | 55.1 | 3.14% | 42.9% |
| 5 | ENVESTNET 1.75% 2019-12-15 | 88.50 | 29.90 | 76.0 | 74.9 | 78.1 | 4.84% | 86.1% |
| 6 | ANI 3.00% 2019-12-01 | 94.25 | 41.37 | 74.8 | 79.2 | 66.2 | 4.55% | 58.3% |
| 7 | WEB.COM 1.00% 2018-08-15 | 97.00 | 22.80 | 74.5 | 78.3 | 66.8 | 2.10% | 48.9% |
| 8 | IGI 3.50% 2019-12-15 | 95.25 | 7.94 | 73.6 | 81.5 | 57.8 | 4.77% | 35.4% |
| 9 | QIHOO 1.75% 2021-08-15 | 88.50 | 54.89 | 73.4 | 75.4 | 69.2 | 5.11% | 94.7% |
| 10 | MERCADOLIBRE 2.25% 2019-07-01 | 100.50 | 95.72 | 72.9 | 69.6 | 79.4 | 2.11% | 32.3% |
| 11 | RESTORATION 0.00% 2020-07-15 | 101.50 | 101.28 | 72.8 | 70.2 | 78.1 | -0.31% | 18.4% |
| 12 | CTRIP.COM INTER LTD. 1.00% 2020-07-01 | 96.75 | 71.05 | 72.5 | 81.4 | 54.6 | 2.25% | 48.1% |
| 13 | E-HOUSE 2.75% 2018-12-15 | 96.00 | 6.56 | 72.4 | 63.9 | 89.5 | 6.42% | 114.7% |
| 14 | CALAMP 1.63% 2020-05-15 | 99.50 | 19.99 | 72.3 | 76.9 | 63.0 | 1.74% | 37.3% |
| 15 | BROADSOFT 1.00% 2022-09-01 | 101.00 | 31.46 | 72.2 | 80.8 | 55.1 | 0.85% | 24.3% |
| 16 | 51JOB 3.25% 2019-04-15 | 99.50 | 32.06 | 71.5 | 63.1 | 88.3 | 3.60% | 32.7% |
| 17 | HERBALIFE 2.00% 2019-08-15 | 89.75 | 55.74 | 70.4 | 71.1 | 69.1 | 4.98% | 38.9% |
| 18 | INVENSENSE 1.75% 2018-11-01 | 94.00 | 10.57 | 70.2 | 64.5 | 81.8 | 3.87% | 94.7% |
| 19 | FIREEYE 1.63% 2035-06-01 | 88.50 | 31.00 | 70.2 | 79.2 | 52.1 | 3.60% | 73.5% |
| 20 | LINKEDIN 0.50% 2019-11-01 | 100.25 | 197.90 | 70.0 | 63.3 | 83.5 | 0.44% | 49.2% |

Sources: Bloomberg, Kynex

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## Hillside HOCS 20 List ex China

| | Description | Convert | Stock | HOCS Overall | HOCS Growth | HOCS Safety | Yield | Premium |
|---|---|---|---|---|---|---|---|---|
| 1 | HORIZON PHARMA INV LTD 2.50% 2022-03-15 | 98.00 | 19.27 | 82.3 | 84.9 | 77.1 | 2.84% | 45.7% |
| 2 | ISIS PHARMACEUTICALS INC 1.00% 2021-11-15 | 96.75 | 44.62 | 81.4 | 82.7 | 78.6 | 1.56% | 44.9% |
| 3 | ENVESTNET 1.75% 2019-12-15 | 88.50 | 29.90 | 76.0 | 74.9 | 78.1 | 4.84% | 86.1% |
| 4 | ANI 3.00% 2019-12-01 | 94.25 | 41.37 | 74.8 | 79.2 | 66.2 | 4.55% | 58.3% |
| 5 | WEB.COM 1.00% 2018-08-15 | 97.00 | 22.80 | 74.5 | 78.3 | 66.8 | 2.10% | 48.9% |
| 6 | IGI 3.50% 2019-12-15 | 95.25 | 7.94 | 73.6 | 81.5 | 57.8 | 4.77% | 35.4% |
| 7 | MERCADOLIBRE 2.25% 2019-07-01 | 100.50 | 95.72 | 72.9 | 69.6 | 79.4 | 2.11% | 32.3% |
| 8 | RESTORATION 0.00% 2020-07-15 | 101.50 | 101.28 | 72.8 | 70.2 | 78.1 | -0.31% | 18.4% |
| 9 | CALAMP 1.63% 2020-05-15 | 99.50 | 19.99 | 72.3 | 76.9 | 63.0 | 1.74% | 37.3% |
| 10 | BROADSOFT 1.00% 2022-09-01 | 101.00 | 31.46 | 72.2 | 80.8 | 55.1 | 0.85% | 24.3% |
| 11 | HERBALIFE 2.00% 2019-08-15 | 89.75 | 55.74 | 70.4 | 71.1 | 69.1 | 4.98% | 38.9% |
| 12 | INVENSENSE 1.75% 2018-11-01 | 94.00 | 10.57 | 70.2 | 64.5 | 81.8 | 3.87% | 94.7% |
| 13 | FIREEYE 1.63% 2035-06-01 | 88.50 | 31.00 | 70.2 | 79.2 | 52.1 | 3.60% | 73.5% |
| 14 | LINKEDIN 0.50% 2019-11-01 | 100.25 | 197.90 | 70.0 | 63.3 | 83.5 | 0.44% | 49.2% |
| 15 | DYCOM INDUSTRIES INC 0.75% 2021-09-15 | 102.00 | 75.20 | 69.4 | 77.5 | 53.3 | 0.41% | 31.4% |
| 16 | TESLA 1.25% 2021-03-01 | 91.00 | 227.01 | 68.4 | 74.7 | 55.8 | 3.08% | 44.3% |
| 17 | FIREEYE 1.00% 2035-06-01 | 90.25 | 31.00 | 67.3 | 73.9 | 54.1 | 3.30% | 76.9% |
| 18 | TESLA 0.25% 2019-03-01 | 93.25 | 227.01 | 67.2 | 71.2 | 59.3 | 2.35% | 47.8% |
| 19 | SOLARCITY CORP 2.75% 2018-11-01 | 92.50 | 44.16 | 67.1 | 79.2 | 42.9 | 5.47% | 29.2% |
| 20 | ECHO 2.50% 2020-05-01 | 93.25 | 21.99 | 67.0 | 70.7 | 59.8 | 4.15% | 66.0% |

Sources: Bloomberg, Kynex

# Euro Gang of 20

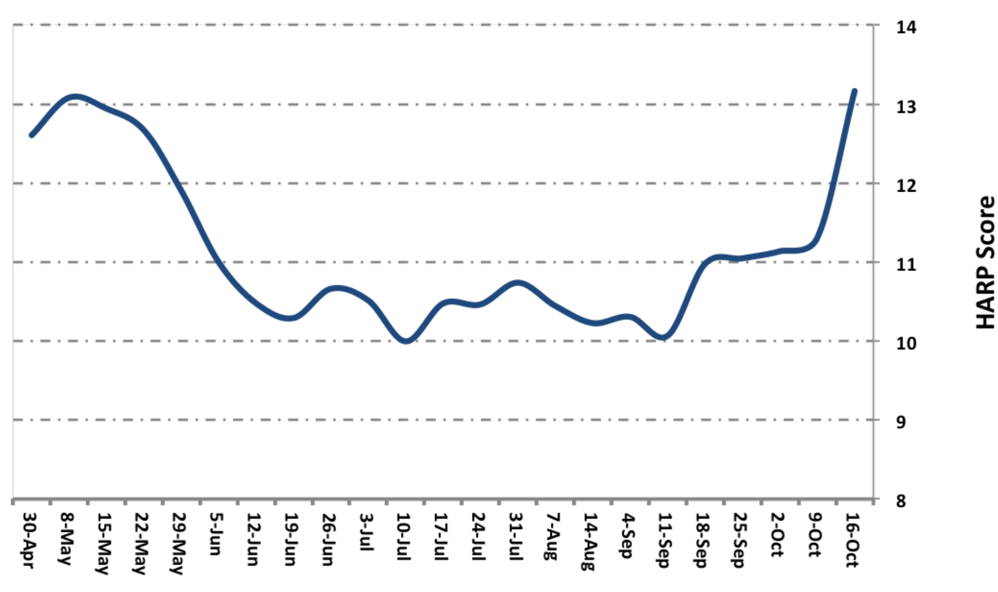
Roman Terekhin, CFA
roman@hillsideadvisors.com

What Comes Down May Go Up

After selling off in the first half of the past week, European equity markets managed a comeback on Thursday and Friday to end the period essentially flat. The stocks underlying the Euro Gang of 20 (Euro-denominated convertibles with least attractive risk/reward profiles as indicated by our HARP rating system) were up 0.3% (or down 0.5% if we exclude Adidas and Nexity stocks, both of which were up over 7%). The average HARP score of the bonds on the list increased 0.25 to 9.36, which is a significant richening. We should point out that the lion's share of this advance is accounted for by only two securities: Adidas AG 0.25% of 2019 and Nexity SA 0.625% due 2020.

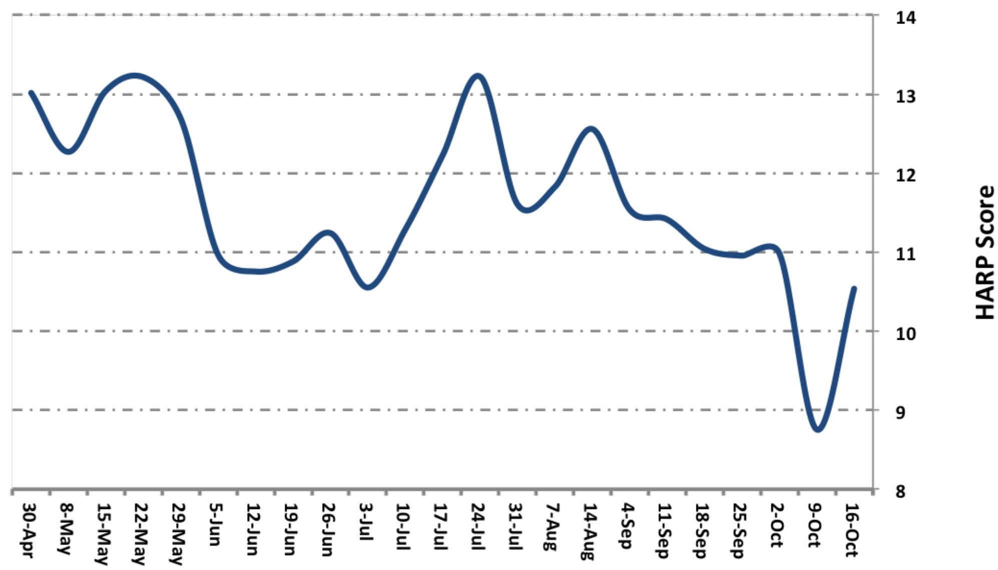
The composition of the list remained very similar to last week's with only Nexans SA 2.5% of 2019 replacing Astaldi SPA 4.5% of 2019 in the 20th place. There was some rather significant reshuffling and Adidas AG 0.25% of 2019 managed to move up four positions to become the new runner-up. With a HARP score of 13.2 (up 1.86 from last week) this security now is a legitimate challenger to the seemingly well-established leader – Fresenius Medical Care A 1.125% 2020 with a HARP score of 13.7 (down 0.15).
While Adidas stock advanced 7.4% for the week, the 0.25s premium went from 26.9 to 25.1 points – not as large a contraction as one would expect for such an equity move. The bond is a regular on our register of the most expensive Euro-denominated converts, but currently it is the richest it has been since we started keeping track back in April – see chart below.

Adidas AG 0.25% 2019, Historical HARP Score



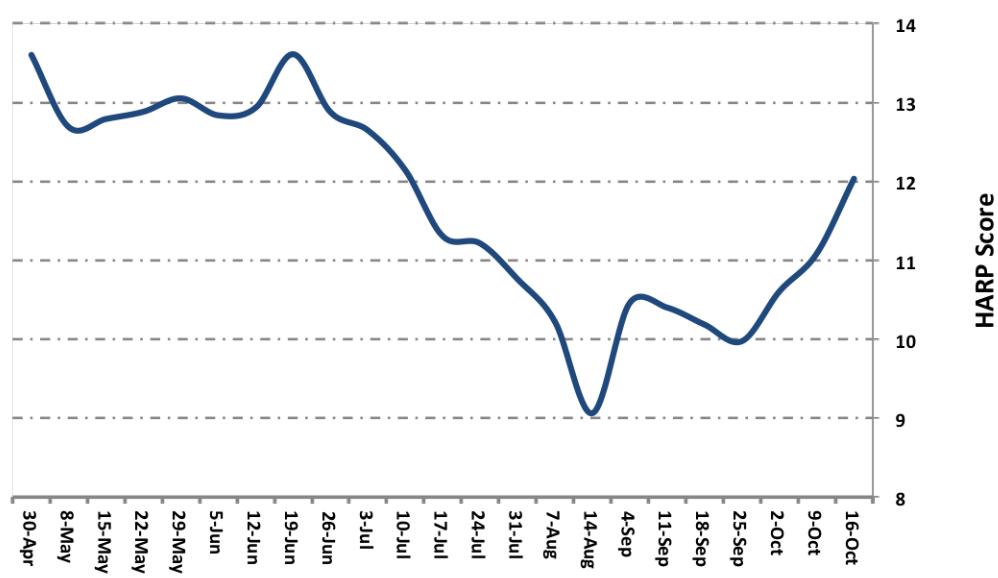

Another bond that saw a significant increase in its HARP score was Nexity SA 0.625% due 2020. Its underlying stock increased in value 7.8% last week, while the bond's premium shrank only 1.3 points. As a result, its HARP score went up 1.8 points to 10.53 pushing the instrument up four positions on the Gang of 20 list. This move in HARP almost eliminated the cheapening that occurred the week before.

Nexity SA 0.625% 2020, Historical HARP Score




Lastly, Fresenius Se & Co 0% of 2019 saw its HARP score go up by almost one point. The stock was up 2.3% for the week and the bond's conversion premium actually expanded by almost a point. This caused the HARP ascent that started in mid-August to continue unabated.

Fresenius Se & Co KGAA 0% 2019, Historical HARP Score




Most other securities on the list moved one or two positions in relation to one another, each gaining or losing less than one HARP point – not much to report in other words. Perhaps we'll have to wait until the Fed moves to bring some real excitement to this section of Hybrid Vigor.

## Euro HARP 20 (Prices as of October 16, 2015)

| | Convertible | Price | Stock | Premium (%) | Premium (pts) | HARP |
|---|---|---|---|---|---|---|
| 1 | Fresenius Medical Care A 1.125% 2020 | 123.30 | 73.07 | 24.26 | 24.07 | 13.83 |
| 2 | Suez Environnement 0% 2020 | 21.64 | 16.74 | 29.31 | 4.91 | 12.04 |
| 3 | Rag-Stiftung 0% 2021 | 113.37 | 31.15 | 34.09 | 28.82 | 11.51 |
| 4 | Adidas AG 0.25% 2019 | 114.83 | 72.14 | 30.54 | 26.86 | 11.31 |
| 5 | Cap Gemini Sogeti 0% 2019 | 86.24 | 76.25 | 13.10 | 9.99 | 11.28 |
| 6 | Fresenius Se & Co KGAA 0% 2019 | 128.70 | 57.86 | 10.46 | 12.18 | 11.08 |
| 7 | Buzzi Unicem SPA 1.375% 2019 | 120.48 | 14.99 | 28.49 | 26.71 | 10.58 |
| 8 | SAF-Holland Group 1% 2020 | 123.29 | 13.34 | 13.99 | 15.13 | 10.21 |
| 9 | Deutsche Post AG 0.6% 2019 | 132.39 | 26.36 | 3.62 | 4.63 | 9.14 |
| 10 | OCI NV 3.875% 2018 | 116.25 | 24.30 | 36.22 | 30.91 | 9.13 |
| 11 | Nexity SA 0.625% 2020 | 47.80 | 35.49 | 27.93 | 10.43 | 8.75 |
| 12 | NH Hotel Group SA 4% 2018 | 122.94 | 5.17 | 16.98 | 17.84 | 8.68 |
| 13 | Rag-Stiftung 0% 2018 | 109.48 | 31.15 | 32.65 | 26.95 | 8.44 |
| 14 | ACS Actividades Fin 2 1.625% 2019 | 110.81 | 6.18 | 13.76 | 13.40 | 7.97 |
| 15 | Acciona S.A. 3% 2019 | 128.55 | 71.88 | 9.47 | 11.12 | 7.96 |
| 16 | ACS Actividades Finance 2.625% 2018 | 118.21 | 6.18 | 7.62 | 8.37 | 7.26 |
| 17 | Prysmian SPA 1.25% 2018 | 109.15 | 19.18 | 26.99 | 23.20 | 6.63 |
| 18 | Societa Iniz Autostradal 2.625% 2017 | 109.57 | 9.91 | 16.15 | 15.24 | 6.25 |
| 19 | Parpublica 5.25% 2017 | 106.90 | 10.04 | 58.54 | 39.47 | 5.39 |
| 20 | Astaldi SPA 4.5% 2019 | 122.89 | 8.45 | 7.61 | 8.70 | 5.34 |

Sources: Bloomberg

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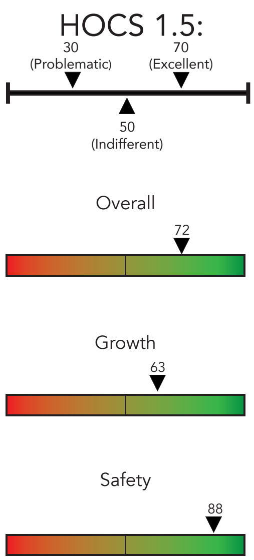
# 51JOB, INC. (JOBS): Safety With a Capital S

**JOBS**

3.25% 2019/04/15
Price (Bond) = 99.50
Stock = $32.06
YTP = 3.60%
Premium = 32.7%
HOCS-Overall = 72
HOCS-Growth = 63
HOCS-Safety = 88

As of October 16, 2015




Jeffrey Alton, CFA
jeffrey@hillsideadvisors.com

51job is a leading integrated human resources service provider in China. Traditionally, its largest business is online recruitment services with job postings that cover a wide variety of employment classifications from professionals to hourly workers. Because of its internet presence, listings are slanted to the Internet-using population which is comprised generally of white-collar professionals ages 20 - 35. 51job is likely the largest online recruitment services provider in China with the company reporting 84 million accounts and 75 million resumes posted on the website as of December 31, 2014. Revenue is derived from advertising on the site and a recruitment platform used by company clients.

51job current outstanding convertible HOCS score is 72 overall/ 63 growth/ 88 safety. The high safety score results from the company's large cash balance relative to its outstanding debt, which is comprised only of the company's US$ 172.5 million 3.25% 4/2019 convertible bonds. One caveat regarding the safety of the convertible bonds is the company's VIE structure. Hillside has covered the risks regarding the VIE structure used by many Chinese convertible bond issuers, so give us a call if you would like to have a more in-depth discussion, but suffice it to say that bondholders may have limited recourse to the company's assets in the event of a default on the bond.

51job was an early entrant in the Chinese recruitment market, beginning operations in 1988 primarily as a print recruitment advertiser. Over time, the company has moved its products online while participating successfully in the rapid expansion of the Chinese economy, growing revenues from US$58 million in 2004 to $305 in 2014 - a compound annual increase just shy of 20%.

Growth has been more difficult to come by recently as the Chinese economy has slowed. Yet with a track record of investing prudently, management that sticks to the business that it knows, a sizeable cash balance to cushion any unexpected events and a yield above 3%, it is a bond worth considering.

## Business Summary

51job is a leading integrated human resources service provider in China. Its largest, and traditional business, is online recruitment services with job postings that cover a wide variety of employment classifications from professionals to hourly workers. Because of its internet presence however, listings are slanted to the Internet-using population which is comprised generally of white-collar professionals ages 20 - 35. 51job is likely the largest online recruitment services provider in China with the company reporting 84 million accounts and 75 million resumes posted on the website as of December 31, 2014. Revenue is derived from advertising on the site and a recruitment platform used by company clients.

51job is winding down its print advertisement recruiting operations, which appeared as inserts included in local papers. The print editions are being eliminated as Chinese society moves online and newspapers lose their advertising efficiency. In 2014, the company sold print advertising in only one Chinese city, down from seven cities in 2012.

The company is also developing additional human resource related products including benefits processing, training, campus recruitment and executive search.

A revenue comparison by segment of year-end 2010, year-end 2014 and the most recent quarter highlights the shift in revenue away from print toward online recruitment and other human resource services.

| (RMB Thousands) | 2010 | | 2014 | | Q2 2015 | |
|---|---|---|---|---|---|---|
| Online Recruitment | 543,045 | 50% | 1,248,101 | 66% | 335,683 | 66% |
| Print Advertising | 277,645 | 25% | 14,247 | 1% | 1,239 | 0% |
| Other Human Resource Related | 269,305 | 25% | 634,945 | 33% | 171,078 | 34% |
| Totals | 1,092,005 | 100% | 1,899,307 | 100% | 508,000 | 100% |

The company has shifted its marketing efforts toward small and medium sized Chinese companies as the large-company market is already highly penetrated. However, with the current softness in the Chinese economy, 51job is more focused on cross-selling its human resources products to existing clients versus obtaining new customers.

In the second quarter of 2015, 51job completed the acquisition of Yingjesheng, a leading recruitment website targeting college graduates and students. The company also recently invested in Zhiding Youyuan, which provides talent assessment tests and tools for corporations.

## Leverage

51job's financial position is strong as recognized by the HOCS 88 safety score. While 51job, along with most Chinese companies, does not provide quarterly cash flow statements, the company cranked out US $121.8 million in cash flow from operations in 2014.

As of June 30, 2015, the cash balance stood at $745 million. The company's only debt is the $172.5 million 3.25% convertible note due April 2019.

## Conclusions

The 51job 3.25% 2019 convertible bond offers purchasers the opportunity to invest in a growing business at a reasonable yield. One other feature of the bond is the April 2017 put which allows investors a chance to sell the bonds back to the company at 100% of face value. Given the current cash balance of the company, we see little risk of default over the next 18 months, and the put is priced for investors to exit at a small profit even if the Chinese economy experiences a hard landing near-term.

Over the longer term, 51job should grow along with the overall Chinese economy, and is focused on a market with long-term potential – human resources management. Human resource policies and work place regulation are still in the nascent stages in China and offer plenty of potential over the longer term.

While margins have contracted slightly during the current China slowdown and competition has arisen from

## Credit Waterfall

| 51job, Inc. (JOBS)<br>(Dollars in Millions) | 30-Jun-15 | Total Debt (Cum. Bal.) | Adj. EBITDA Multiple | Net Debt (Cum. Bal.) | Adj. EBITDA Multiple |
|---|---|---|---|---|---|
| Current Share Price | $32.06 | | | | |
| Shares Out. (Millions) | 59.4 | | | | |
| Latest Twelve Months: | | | | | |
| EBITDA (Adj.) | 85 | | | | |
| Cash & Cash Equivalents | 745 | | | | |
| Senior Unsecured Debt | | | | | |
| 3.25% Senior Cvt. Notes due 2019 (1) | 173 | 173 | 2.0x | -572 | -6.7x |
| Total Debt | 173 | 173 | 2.0x | -572 | -6.7x |
| Equity Market Cap. | 1,904 | --- | --- | --- | --- |
| Enterprise Value | 1,332 | --- | --- | --- | 15.6x |

(1) Reflects principal amount of convertible securities outstanding, unadjusted for unamortized debt discount.
Source: Company Filings/Bloomberg

## Financial Summary

| JOBS<br>(Dollars in Millions) | Fiscal Years Ended 31-Dec-10 | 31-Dec-11 | 31-Dec-12 | 31-Dec-13 | 31-Dec-14 | LTM 30-Jun-14 | 30-Jun-15 | Quarter Ended 30-Jun-14 | 30-Jun-15 |
|---|---|---|---|---|---|---|---|---|---|
| Revenues | 156 | 206 | 232 | 266 | 295 | 220 | 310 | 73 | 80 |
| Y / Y Change | ---- | 32.0% | 12.5% | 14.4% | 11.1% | ---- | 41.0% | --- | 9.9% |
| Gross Profit | 104 | 148 | 167 | 193 | 215 | 160 | 225 | 53 | 58 |
| Operating Profit | 41 | 70 | 78 | 81 | 84 | 63 | 85 | 20 | 20 |
| EBITDA | 46 | 75 | 83 | 86 | 92 | NA | NA | NA | NA |
| Interest Expense | 0 | 0 | 0 | 0 -- | | NA | NA | NA | NA |
| Income Tax Expense | 9 | 13 | 15 | 17 | 18 | 13 | 19 | (5) | 5 |
| Capital Expenditures | 4 | 9 | 22 | 37 | 5 | NA | NA | NA | NA |
| % Revenues | 2.3% | 4.5% | 9.4% | 13.8% | 1.8% | NA | NA | NA | NA |
| Free Cash Flow | 49 | 70 | 70 | 87 | 116 | NA | NA -- | -- | |
| Total Debt | 0 | 0 | 0 | 0 | 179 | 28 | 174 | 174 | 174 |
| % Total Debt | NM | NM | NM | NM | 65.0% | NA | NA | NA | NA |
| Gross Margin | 66.5% | 71.5% | 72.0% | 72.5% | 72.9% | 72.8% | 72.5% | 71.9% | 72.8% |
| Operating Margin | 26.4% | 33.9% | 33.5% | 30.4% | 28.6% | 28.8% | 27.5% | 27.4% | 24.6% |
| EBITDA Margin | 29.2% | 36.1% | 35.6% | 32.5% | 31.2% | NA | NA | NA | NA |
| EBITDA / Interest | NM | NM | NM | NM | NA | NA | NA | NA | NA |
| EBITDA - Capex / Interest | NM | NM | NM | NM | NA | NA | NA | NA | NA |

Source: Company Filings/Bloomberg

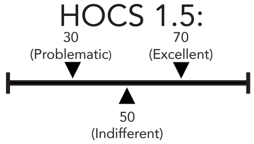
# SouFun Holdings Ltd. (SFUN): Brokers Inflate Transaction Counts

SFUN

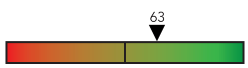
2% 2018/12/15
Price (Bond) = 94.75
Stock = $7.06
YTP = 6.83%
Premium = 163.3%
HOCS-Overall = 63
HOCS-Growth = 54
HOCS-Safety = 81

As of October 16, 2015

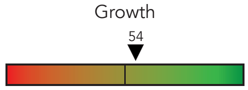
HOCS 1.5:




Overall




Growth




Safety


Jeffrey Alton, CFA
jeffrey@hillsideadvisors.com

In a scandal that was not covered widely in the US press, SouFun discovered that its brokers inflated their transaction numbers to earn base salaries. SouFun increased the minimum transaction number from 6 to 12 in April and brokers responded by faking transactions to meet the new targets.  About 1,500 brokers were fired due to the scandal, although that number was not confirmed by the company.

Cheating on the transaction number proved easy because brokers only needed to submit paper work, not actual funds into the system in order to gain credit for the sale. The cheating was only discovered by the company when they again changed the commission structure and reported sales fell. The scandal highlights the current slowdown in the Chinese real estate market and the difficulty brokers have in meeting targets.

SouFun stock and the 2% December 2018 convertible bond appear to be unaffected by the scandal, perhaps because the news was under-reported here in the US.

SouFun has a HOCS rating of 63 overall/54 growth/81 safety.  The high safety score is a result of the company's ability to generate free cash flow – over $600 million in the last two calendar years.  The bond trades at 94.75 versus a stock price of $7.06/share with a yield to maturity of 3.8%. Please refer to the June 15 edition of Hybrid Vigor for a more in-depth discussion of SouFun's business and its prospects.

While the scandal may result in a revenue guidance miss in the short-term, we continue be constructive towards SouFun for investors who wish to position themselves for an eventual rebound in the China real estate market.

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October 19, 2015

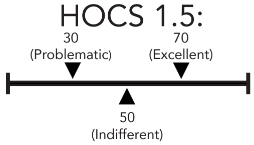
# SanDisk (SNDK): Size & Scale Take Center Stage

**SNDK**

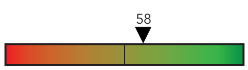
0.5% 2020/10/15
Price (Bond) = 104.75
Stock = $69.97
YTM = -0.44%
Premium = 37.3%
HOCS-Overall = 58
HOCS-Growth = 54
HOCS-Safety = 67

As of October 16, 2015

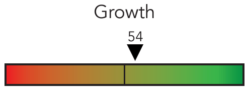
HOCS 1.5:




Overall




Growth




Safety


George Lynch
glynch@hillsideadvisors.com

## Introduction

The hottest ticket on Broadway these days is for a musical entitled "Hamilton", a show inspired by Ron Chernow's biography of Alexander Hamilton. And, the hottest ticket in merger and acquisition land is the consolidation of the global semiconductor industry. The curtain rose on this show several months ago. This year has already seen $79 billion in deals announced. It all comes down to a tremendous need for capital in order to fund exorbitant capital spending requirements. Hence, this wave of industry consolidation is much needed, and frankly, long overdue. Consider this to be only the first act in a likely two act show. Music to the ears of Wall Street M&A types.

## Enter SanDisk

Now, SNDK appears ready to join the party. Last week, SNDK announced that it has retained a financial advisor to explore the sale of the company. This comes on the heels of the company having received expressions of interest from chipmaker Micron Technology (MU) and hard disk drive manufacturer Western Digital (WD). A potential deal makes sense for all parties from strategic points of view. However, settling upon a purchase price would not be so straightforward.

As we have already begun to discuss, a total of five semiconductor deals have been struck this year alone. The five deals ranged in size from $2.1 billion to $36.7 billion. The largest of the bunch, Avago Technologies' acquisition of Broadcom commanded a nearly 19 times purchase price multiple, one of the lower multiples paid vis-à-vis this year's five transactions. SNDK currently boasts a $15 billion enterprise value, translating into an 8.2 times enterprise multiple. So, what is a company interested in merging with or acquiring SNDK in its entirety realistically going to be willing to pay?

Until recently, the Avago/Broadcom transaction stood as the largest technology merger of all time. However, this soon appears likely to be topped by Dell's $67 billion bid for EMC. SNDK's stock closed around $70 last week, but it's up several points as we get ready to go to press. The stock reached a several year peak of roughly $105 last year. All other things being equal, that would imply a $22 billion enterprise value and suggest a 12 times multiple, a full price by our reckoning. One "buzz" this morning suggested a price close to that level. We have not conducted a comprehensive merger analysis or attempted to evaluate the maximum debt leverage that could be incurred in an acquisition of SNDK.

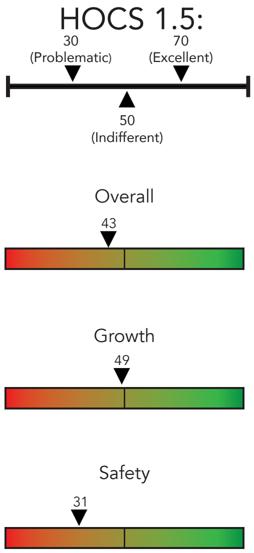
## The SanDisk Convertibles

The more balanced SNDK 0.5% Convertible Senior Notes due 2020 appear to have lagged somewhat since the takeover buzz began last week, reflecting greater exposure to premium loss in a possible cash takeout even with the benefit of a make-whole. But there's still substantial risk on the upside, probably on the order of 5-6 points with a theoretical hedge. Probably best to lean light, as painful as that may be after a big rally: a 50%-ish hedge seems in order, though it will sting if all the buzz subsides. That's the world of a

**SNDK**

1.5% 2017/08/15
Price (Bond) = 149.25
Stock = $69.97
YTM = -19.73%
Premium = 8.1%
HOCS-Overall = 43
HOCS-Growth = 49
HOCS-Safety = 31

As of October 16, 2015




bond with roughly the same premium around 107 (versus $73.50 as we write) as it had at issuance two years earlier.

The older 1.5% Convertible Senior Notes due 2017 (at 155.5 vs $73.50) appear to be in pretty good shape for a takeout on a 90% hedge or thereabouts. For unhedged buyers, who presumably will continue to favor the 0.5%, the big-picture risk-reward profile is still decent, with an upside roughly twice the downside assuming a possible takeout around $100 per share and reasonably solid price support just above par.

### Semiconductor Sector Consolidation – A Brief Overview

In many respects, the wave driving semiconductor sector consolidation resembles the old “build versus buy” capital investment dilemma. Throughout the industry, costs have been rising at a rapid rate. Moreover, players of all sizes and areas of expertise are finding it increasingly difficult to compete on a global scale. In particular, semiconductors continue to grow faster and increasingly more capable. And, as the cost of a new facility to produce more sophisticated chips (or, systems on a chip) continues to rise, companies have found themselves in a quandary.

The price tag associated with building a state-of-the-art facility could run as high as several billion dollars. Intel recently spent approximately $5 billion on a new chip manufacturing facility (Arizona). And, TSMC spent more than $9 billion on a wafer manufacturing operation (Taiwan). Ultimately, an investment of this size might not be worth it from a return on investment standpoint given all of the attendant risks and uncertainties. So, what is a U.S. semiconductor company to do before breaking ground on that new facility?

A company has several options at its disposal. Selling various non-core assets, licensing certain technologies, or selling patent portfolios in part or in their entirety is one course of action. Partnering with a foreign entity is another option worth exploring as well. A leading actor on this stage is China. Specifically, the Chinese government has committed itself to investing $100 billion over the coming handful of years to grow a national semiconductor industry. However, Chinese investment in a U.S. semiconductor company, especially where a transfer of control is involved, could face a U.S. Committee on Foreign Investment review. A merger or acquisition with another U.S. player may be the way to go, even if it demands a “full” purchase price.

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